

WisdomTree MINDS ON THE MARKETS



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Inverted Yield Curves, but Still No Recession

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Remember when inverted Treasury yield curves were all the rage? And, of course, what would follow if history was any guide? A U.S. recession.

Well, the two most widely followed UST yield curves (3-month vs. 10-year and 2-year vs. 10-year) both went into negative territory on a consistent basis during the second half of 2022, and here we are almost 1 1/2 to 2 years later and still no recession to speak of, at least not yet anyway.

Interestingly, the economy did enter into the textbook definition of a recession back in the first half of 2022. Indeed, real GDP posted two consecutive negative quarters in Q1 and Q2 of that year, but this downturn actually occurred before the yield curves went inverted.

So, why did the markets get so apoplectic about an inevitable recession once the Treasury curves went inverted this time around? Given the H1 2022 experience of negative real GDP in isolation, could it be that inverted curves transformed into a lagging, rather than a leading, indicator? Absolutely not. There is no doubt it was due to the historical track record of what has happened in the past.

Going back to 1980, an inverted yield curve foretold the five recessions that followed. While the timing and magnitude of the negative differential varied, the end result was still ultimately an economic downturn. Interestingly, the inversion episode of the summer of 2019 did lead to a recession, but one could question its predictability that time around because real GDP only went negative as a result of the COVID-19 shutdown. Arguably, it is possible a recession would not have occurred in a normal economic cycle not influenced by a once-in-a-generation pandemic.

Back to the present, or perhaps what the future will hold. Similar to the 2019 episode and what the markets are currently witnessing, there is a potential factor that needs to be considered that wasn't operative from 1980 through 2010: the Fed's balance sheet. It seems reasonable that the Fed's quantitative easing (QE) programs may have played a role in how the Treasury yield curve functioned. Prior to the financial crisis, Fed holdings of Treasuries, MBS, etc., were less than \$1 trillion, but they ballooned to about \$4.25 trillion during the first QE programs and then surged to \$8.5 trillion post-COVID-19.

One can't help but think this amount of Fed purchases may have had an impact on the Treasury yield curve to some degree. One line of thought was that given the unprecedented nature of QE, perhaps the inversion needed to be larger and for a longer duration of time to be comparable to past negative spread experiences.

Well, it appears those two criteria were achieved this time around. For the only other time the UST 2-yr/10-yr differential was more inverted, you have to go back to 1980/1981. However, based on incoming economic data, it doesn't appear as if a recession is looming immediately ahead.

Investors are scheduled to receive Q1 2024 real GDP toward the end of this month. Based on the Atlanta Fed's GDPNow gauge, growth is projected to have been +2.8% during the opening three months of this year. While the Treasury yield curve still remains inverted, there's still no recession.

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Glossary

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States.

Federal Reserve balance sheet: Also known as the Fed's H.4.1 statement, this is a financial statement that shows the U.S. central bank's assets, liabilities and capital accounts.

Gross domestic product (GDP): The sum total of all goods and services produced across an economy. Real GDP is adjusted for price changes.

Inverted yield curve: An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

Mortgage-backed securities (MBS): A type of asset-backed security that is secured by a mortgage or collection of mortgages.

Quantitative easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Recession: Two consecutive quarters of negative GDP growth, generally characterized by a slowing economy and higher unemployment.

Treasury (UST): Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Yield curve: Graphical depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

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